centrica

2016 Interim Results

Thursday 28 July 2016

Iain Conn, Group Chief Executive

Thank you very much for coming. Before we begin, just a word on safety in this building. There are no planned fire alarms today and any building evacuation will be announced by tannoy. Emergency exits are marked at the rear and the front of the auditorium and Goldman Sachs staff will direct you to the muster point which is towards the rear of the building on the junction of Stonecutter and St Brides Street.

As usual I'm joined here today by Jeff Bell, our Group Chief Financial Officer. Mark Hanafin, Chief Executive of Energy Production, Trading and Distributed Energy; Mark Hodges, Chief Executive of Energy Supply and Services, UK & Ireland, who also has responsibility of the Connected Home; and Badar Khan, Chief Executive, Energy Supply and Services for North America.

After some brief introductory comments from me, Jeff will take you through our first half results presentation. I'll then provide you with an update on the progress we've made in implementing our strategy, before Mark, Mark and Badar join us on the stage to take your questions. We expect the presentation will last about 50 minutes. We're also joined today on the front row by our Chairman, Rick Haythornthwaite, and other members of the Executive Committee.

So what are the key messages we hope you take away today?

Financial performance in the first half was encouraging, despite a weaker external environment. Earnings were down 14%, reflecting extreme warm weather in North America, lower commodity prices and a 3% fall, or in fact 2.7% fall, in energy customers in the UK, offset by progress in our underlying performance and efficiency programme.

Adjusted operating cash flow of £1.4bn was up 19%, despite the fall in earnings, including an element of strong working capital delivery in UK Business.

The first half result also benefited from strong progress on our cost efficiency programme. Jeff will cover this in more detail later, but like-for-like costs were down in the first half compared to last year and we now expect to deliver around £300m of savings in 2016, up from our target of £200m announced in February.

As part of our reorganisation and efficiency programme, we saw material headcount reductions over the first half and remain on track to reduce direct headcount by 3,000 over the course of the full year, that's like-for-like direct headcount. We've made good progress on implementing our strategy in all parts of the company. I'll come back and cover this in more detail after Jeff's presentation.

Our 2016 full year cash flow and other financial targets are underpinned. As a result of the strong operating cash flow delivery, combined with control over capital expenditure, we saw significant net cash inflow in the first half of the year, even before the impact of our equity placing. Having delivered £1.4bn of adjusted operating cash flow in the first half we remain on track to deliver in excess of £2bn in 2016. And importantly, we have a stronger balance sheet with net debt at the half year of £3.8bn. This reflects the strong net cash flow generation during the first half, the sale of the GLID wind farm and the equity we raised in May, partly offset by the acquisition of ENER-G Cogen which closed in May. We expect the announced acquisition of Neas Energy to complete in the second half.

We referred at the time of the equity placing to continuing uncertainties in the world around us. I'd like to cover briefly key elements of the current context and how we see them.

Year-on-year we've seen significant weakness in commodity prices, but in recent months have seen some recovery from the lows of January and February. Oil prices have recovered to $45, well maybe a bit less than that this morning, $45 to $50 a barrel, and forward prices for natural gas to over 40 pence per therm. However, they remain below last year's levels and much lower than the peaks of a couple of years ago. This means it's not straightforward to divest of E&P assets as we look to move to a smaller, more focused E&P business.

The UK regulatory and political environment is also evolving. We've seen the publication of the final CMA report and we believe that many of the remedies will further enhance the market and benefit customers. The clarity is very important, and although we have some issues with one or two of the conclusions, equally the ability to be able to innovate in providing a larger number of new offers to our customers will be a major step forward. Centrica's contributed fully to what's been a thorough and in-depth investigation and we'll work with all interested parties to deliver the best outcome for our customers.

The UK Government is also implementing changes to the UK capacity market, including holding an auction a year earlier than originally planned, buying more capacity and shifting the balance between the 'year ahead' and 'four years ahead' periods. We believe the changes are constructive and will help provide additional clarity in the investment climate for thermal generation in the UK.

The Brexit vote does create additional uncertainty and challenges for businesses in all sectors, with implementation plans as yet unclear. One important step to reduce uncertainty and create momentum has been the swift change to the leadership and senior posts within the Conservative Government. Overall, we believe the direct impacts on Centrica are limited in the short term to those common impacts felt by businesses in general from things like confidence, interest rates and foreign exchange.

Over time, our focus is on understanding what the result means for energy regulations and how the changed involvement of the UK would impact the competitiveness of the European energy markets. The UK's now a major energy importer and what happens in the European energy market will ultimately impact energy consumers in the UK. We'll continue to engage with the UK Government and the European Commission as we move forward.

Competition in energy supply remains intense. Since the CMA started its investigation two years ago competition in the UK market has continued to increase, with the number of residential energy suppliers growing from 25 to 44 at the last count. We saw residential energy account numbers fall by about 3% in the first half as a result of increased competition, some large contract roll-offs and the constraints on innovation due to limits on the number of tariffs we could offer.

However, this is not simply about customer numbers and our focus will be on delivering great offers which customers want, and to target the customer segments who want them. The actions we're taking in all our geographies on customer service, offer development and cost efficiency leave us well placed to succeed in competitive markets and indeed in both Ireland and North America we've seen stable customer numbers this year.

Finally, as we identified in our strategic review last year, the shift to more distributed energy systems is a significant global trend. In B2B we believe distributed generation will take power market share and create material new gross margin pools over the next 20 years. This shift away from centralised power generation will require new capabilities and our recently announced acquisitions of Panoramic Power, ENER-G Cogen and Neas Energy materially accelerate our growth potential in this area.

The distributed energy trend is also affecting the residential market and customers are enjoying increased choice and more control, and new offers and the competitive landscape continue to develop rapidly. We've established a strong starting position in Connected Home, with our bestselling Hive smart thermostat and other Hive products, and our connected boiler, Boiler IQ. We believe the Connected Home will become an important source of differentiation and a key component of our B2C offering.

So having set out the strategic context I'll now hand over to Jeff.

Jeff Bell, Group Chief Financial Officer

Thank you, Iain, and good morning everyone. I'll start with the commodity environment, then cover the financial headlines and review business unit results, before finishing on cash flow and net debt.

As you can see from the charts, average market oil and gas prices were materially lower in the first half of 2016 than the same period in 2015. These lower prices impacted both the realised sales prices, and profitability, we achieved in our Exploration & Production and Central Power Generation businesses. However, lower commodity prices also meant that our Home and Business energy supply customers benefited from reduced prices.

After reaching recent lows early in the year, commodity prices have seen a partial recovery, most notably in oil where Brent prices are currently around $45 per barrel. NBP and Henry Hub gas prices and UK baseload power prices have also risen, although not to the same extent.

With the commodity prices as a backdrop I'll move on to the financial headlines.

Revenue decreased 13% compared to the first half of 2015, primarily driven by lower realised prices in E&P and power, reduced consumption in North America due to extreme warm weather, and lower tariffs in all of our energy supply businesses. Adjusted operating profit fell 12% to £853m, which I'll review in more detail shortly.

The adjusted effective tax rate was slightly down to 28%. Overall, adjusted earnings for the Group reduced by 14% to £507m, equivalent to 9.8 pence per share. The interim dividend per share is 3.6 pence, 30% of last year's full year dividend, in line with our established practice.

Adjusted operating cash flow increased by 19% to £1.4bn with strong working capital inflows, particularly from UK Home and Business. Excluding the impact of commodity price moves between the years and also stripping out the impact of the expected additional working capital inflows in UK Business, underlying adjusted operating cash flow increased by 11%. This is in excess of the 3% to 5% per annum growth expectation we set out as part of our strategy last July, but we would expect growth rates to vary over time and in different periods.

Group net investment of £444m rose 16%, but was actually 25% lower excluding material acquisitions and disposals, with the reduction in E&P capital expenditure in particular. Reflecting our strong cash flow focus and the impacts of the equity placing and the ENER-G Cogen acquisition, net debt fell to £3.8bn.

Total post-tax net exceptional charges were £63m and include an impairment of the Rough gas storage asset, gains related to the disposal of the GLID wind farm joint venture and some North Sea E&P assets, restructuring charges related to the cost efficiency programme, and a pension past service credit related to changes to the Centrica pension plan final salary scheme.

Moving now to cover the results of the business units. These are reported for the first time under our new segments, alongside a new suite of key performance indicators. You will also find on our website the 2015 full year financial results of the business units in the new segments for comparison purposes, as well as at the back of this slide presentation.

In Energy Supply & Services UK & Ireland operating profits were down 2% to £690m. Profits in UK Home reduced to £635m, 6% lower than in the same period last year. This primarily reflects lower consumption when compared to a colder than normal 2015, a 3% reduction in the number of customer accounts and a one-off pension credit benefit in 2015. Within the UK Home results, energy supply profitability fell to £516m, down 7% compared to 2015. Initial benefits from the cost efficiency programme kept UK & Ireland unit costs broadly flat to the prior period.

UK Business returned to profitability in the first half, following a loss in the second half of 2015. With the operational issues associated with the migration of customer accounts onto a new billing and customer relationship management system having been rectified, bad debt costs reduced and operating cost improvements began to take hold. Ireland again delivered a good performance with profits slightly up.

Adjusted operating cash flow overall for the UK & Ireland was materially higher, reflecting both permanent recovery of additional working capital built up in UK Business following last years' billing issues, amounting to £278m in the first half, and overall strong working capital management in both UK Home and Business.

In North America operating profit was £95m, 50% down on the same period last year and adjusted operating cash flow was down by a similar percentage, reflecting both the lower profitability and phasing of working capital.

First half results were predominantly impacted by lower consumption as a result of much warmer weather than last year. As you can see in the chart on the bottom left, the much warmer than normal weather in the first half of 2016, and by some measures, parts of the US northeast had their second warmest winter on record. Although some of you will no doubt be thinking of 2014 when the business also experienced a sharp drop in profitability due to weather at the time related to the polar vortex, unlike 2014 the weather this year has masked real underlying growth in the North American business and we expect a much stronger second half performance.

North America Home profit fell 34% to £33m, partly as a result of the warm weather, but also reflecting continuing losses from our solar business. During the second quarter we took action to focus the solar business on its most attractive markets and improve costs, including restructuring our operations, streamlining our sales channels and closing a number of regional offices. Overall the number of services customer account holdings fell, but we saw an increase in higher value protection plan customers. Annualised cost per customer increased, but after normalising for increased higher cost solar installations it was broadly flat.

North American Business profit reduced by 55% to £62m, reflecting lower consumption as a result of the warm weather and low commodity price volatility, which limited the potential for optimising our national gas pipeline and storage capacity contracts. However, net margin under contract heading into the second half is nearly 40% higher than at this stage last year and we would expect to have a strong second half as a result.

Turning now to our three other customer-facing businesses, Connected Home, Distributed Energy & Power and Energy Marketing & Trading. All three businesses reported a reduced operating loss in the first half. Connected Home revenue increased due to higher product sales, although the business reported an operating loss of £23m as we invest to scale up the business. Distributed Energy & Power made an operating loss of £11m, but the business also continued to grow with revenue up 52% to £67m, and active customers more than doubled to around 2,500 including the impact of the ENER-G Cogen acquisition. We expect ENER-G Cogen to make a positive contribution to profit and cash flow in the second half of the year.

Energy Marketing & Trading reported a £14m operating loss, compared to a £55m loss for the comparable period in 2015. Similar to the prior year, in which the business made a full year operating profit of £66m, we chose to optimise a number of our flexible gas contracts for value in the first half of the year. We expect these flexible gas contracts, and associated hedges, to again be profitable in the second half of the year, along with the rest of the Energy Marketing & Trading business.

The year-on-year movement in adjusted operating cash flow followed the underlying changes in the profitability of Connected Home and Distributed Energy & Power. Energy Marketing & Trading adjusted operating cash flow was lower in the first half of 2016, reflecting the phasings of cash flows from the flexible gas contracts.

Turning to Exploration & Production, operating profit was down 17% and adjusted operating cash flow was down 25%. This reflects lower achieved sales prices for gas and liquids, even after the benefit of prior years' hedges, although this was largely offset by lower cash production costs and reduced appreciation.

Production was down 7% to 38 million barrels of oil equivalent. In Europe, total production was down only 2% with strong production from all our Norwegian assets largely offsetting natural decline in our UK and Netherlands fields. In the Americas, total production reduced by 17% as we significantly reduced drilling activity and shut in some production for economic reasons.

Unit lifting and other production costs reduced by 26% to £9.6 per barrel, reflecting our focus on cost reduction, but also benefitting from some phasing of costs between the first and the second half. For the full year we now expect total cost to reduce by around £200m compared to a 2014 baseline, up from £150m announced previously.

As a result of the measures undertaken to reduce operating costs and capital expenditure, reflective of the challenging environment, we were able to improve the free cash flow of the business from £35m in the first half of 2015 to just over £70m in the first half of 2016, in line with our previously stated objective of keeping the business at least free cash flow neutral through 2015 and 2016.

In Central Power Generation operating profit reduced 59% to £24m despite higher gas-fired and nuclear volumes. This reflects the impact of continued low market spark spreads on the gas-fired plant and lower baseload power prices on our nuclear business. Generation from our share of wind assets was 29% lower than the same period last year, mainly due to the disposal of the GLID windfarm joint venture.

Finally, moving to Storage, where seasonal spreads fell to historically low levels in the first half of the year. The 2016/17 standard bundled unit price of 15.4 pence we announced in April was the lowest ever achieved. While other revenue, primarily cushion gas sales, increased over the prior year it was not enough to offset increased costs of operation and adjusted operating profit and adjusted operating cash flow both fell.

The second half result will be materially impacted by the cessation of all injection and withdrawal operations until at least November. As a result, we expect Centrica Storage to report an operating loss for the year.

As you heard from Iain, we are making strong progress on cost reduction. Total operating costs reduced by 1% in the first half of the year, and after adjusting to get to a like-for-like number they were down 6%. Taking into account controllable costs of goods sold, you can see here the progress we have made in delivering our cost targets. £141m of efficiencies were delivered in the first half of the year, a positive start towards realising our 2020 target of £750m. These include headcount reductions in our UK Home division due to site consolidation and streamlining of sales channels and service product lines, and supply chain improvements, most notable in E&P. With the progress we've made to date, and the visibility we have on the efficiency programme for the second half of the year, we now expect to deliver approximately £300m of efficiencies for the full year.

In addition to the efficiency programme savings, we saw other cost reductions compared to the first half of 2015 of £129m. Approximately half of this is cost phasing that we expect to reverse in the second half of 2016. The other half is comprised of reductions in cost that are primarily non-repeating in nature, for instance, one-off charges we took in the first half of 2015 related to tariff costs in E&P. As a result we have excluded counting them towards the efficiency programme targets. In total controllable costs fell by around £230m in the first half of 2016, compared to the prior year, after taking account of inflation.

Turning to net investment, total investment including small acquisitions was £424m, 25% lower than the same period last year. This predominantly reflects the actions we have taken in E&P in response to the low commodity price environment, and capital expenditure was down 31% to £289m. This includes spend on the Cygnus field which is now expected to achieve first gas in Q4 2016. We still expect E&P capital expenditure for the full year to be around £500m.

Capital expenditure in the growth areas of Connected Home, Distributed Energy & Power and Energy Marketing & Trading was also lower than in 2015, which included the acquisition of AlertMe.

The material acquisition in the first half was ENER-G Cogen, while we also realised £112m of disposal proceeds, primarily from the sale of the GLID windfarm joint venture.

Now on to cash flow. In the first half of 2016 we delivered net cash inflow of over £1bn. As you've already heard adjusted operating cash flow rose 19% to nearly £1.4bn. Dividends increased, reflecting a more normal level of scrip take-up, while we also incurred higher exceptional cash flows, mainly associated with the termination of the Rijnmond tolling agreement in the Netherlands and restructuring charges related to the cost efficiency programme.

You also see here the £700m cash inflow from the equity placing. However, even after excluding this and the associated acquisition of ENER-G Cogen, we still generated net cash inflow over £450m. As a result, net debt fell to £3.8bn as I mentioned in the financial highlights.

Following the conclusion of their Review for Downgrade assessment announced in February, Moody’s confirmed in May our Baa1 rating with stable outlook, while S&P currently have a BBB+ with a negative outlook. These ratings are in line with our financial framework of maintaining strong investment-grade credit ratings.

So in summary while earnings were down in the first half by 14%, adjusted operating cash flow increased 19%, and the underlying growth rate of adjusted operating cash flow was 11%. Net debt fell to £3.8bn and our credit ratings remain strong investment-grade.

And finally, lower costs in the first half of the year reflected good progress on our cost efficiency programme. I would now like to hand back to Iain.

Iain Conn

Thank you, Jeff. I’d now like to update you in a bit more detail on the progress we’ve made in the 12 months since we announced the conclusions of our strategic review last July.

First I'm going to remind you of the key aspects of our strategy. I will then cover progress on shifting our portfolio and specifically the repositioning of our E&P and power businesses, and what we’ve done in developing our customer-facing growth platforms.

I’ll then cover the strong progress we’ve made towards achieving our cost targets through our comprehensive cost efficiency programme. I’d also like to remind you of our financial framework and within that how we’re currently thinking about our key growth target, that of 3% to 5% per annum growth in underlying adjusted operating cash flow.

Finally, before summarising I’ll come back to the 2016 targets we set in February and our outlook for the year.

This is the slide we used last July to summarise our strategy. Centrica is an energy and services company with a clear purpose *“to provide energy and services to satisfy the changing needs of our customers”*. What people want in energy and the types of services we offer is changing significantly and we have the skills and capabilities today with which to respond, both for our existing customers and for all those we’ve not yet accessed.

We established the shareholder objective to deliver long-term value through returns and growth, with the focus on our customer-facing businesses. We would reduce scale in E&P and Central Power Generation that would begin with the material reallocation of resources, about £1.5bn over the next five years from E&P and Central Power Generation into our customer-facing businesses. We said we expect to deliver 3% to 5% underlying growth in adjusted operating cash flow per annum out to 2020.

As a major contributor to this growth, particularly in the near-term, we announced a substantial £750m per annum efficiency programme. And finally, we said we would manage the Group's finances to underpin the progressive dividend policy with distributions in line with that underlying operating cash flow growth, and to maintain a strong balance sheet and commensurate strong investment-grade credit rating.

In simple terms this strategy is built around four fundamental dimensions. Firstly the recognition that the world will continue to need more energy, but yet want to use less of it per unit GDP and produce less CO_2 per unit energy.

Secondly, the belief that the world is in the foothills of a major revolution in energy, towards a more distributed system, whether in established or emerging markets, and whether in the Home or in the Business.

Third, that the customer is at the heart of this change, as they gain more choice in how they obtain energy and services and as they demand higher standards.

And, fourthly, the particular skills and capabilities which Centrica has today, which give us the starting point from which to be a leader in such change.

One year on, I am more convinced than ever about these four dimensions.

Will it be easy for Centrica to be a leader in such a transition?

The current environment is certainly a challenge, with low commodity prices, weak economic growth and recently some considerable political uncertainty.

The fundamental trends suggest large market participants in energy will have to change significantly, and that will not be easy. However, from where we begin I think we have a better starting point than many. We have an extensive customer base and experience in serving customers at scale. It will require enhanced customer-facing capabilities, and while we have a great start, we'll need to deepen in many areas and others are seeing the world in the same way. Competition will be intense and quality, efficiency and pace of execution in everything we do will really matter if we want to stay ahead.

As part of this, we'll have to experiment and take a degree of risk, and manage it so that we pursue the right avenues and close off ones which don't work. There is no doubt that there are many challenges, but a year on I would say that for Centrica, provided we think things through, focus on quality and execute well, there are at least as many opportunities.

So how are we doing?

Let me start with the repositioning of our portfolio. In repositioning our asset-heavy businesses we're making good progress, and have cut back our levels of investment into E&P as we look to reduce its scale and as we respond to the current environment. We're targeting a broadly free cash flow neutral E&P business at low prices, and as you heard from Jeff the business was free cash flow positive in the first half of 2016, reflecting the actions we've taken on both capital expenditure and lifting and other cash production costs.

We're on track to deliver our target for E&P to be free cash flow positive over 2015 and 2016 in what has been a very challenging environment. As part of that, we also remain on track to achieve our full-year target for capital expenditure of around £500m, the mid-point of our £400m to £600m targeted range, and consistent with the £1.5bn reallocation of resources away from E&P. We now expect to deliver lifting and other cash production cost reductions of around £200m in 2016, relative to a 2014 baseline. We continue to consider all avenues to make E&P more robust in this environment as we target a portfolio producing 40 to 50 million barrels of oil equivalent per annum.

The low commodity price environment means it's not straightforward to divest of E&P assets, and Canadian gas prices are particularly low at the moment. However we have good quality assets in Canada, which include infrastructure as well as production, and alongside our partners, Qatar Petroleum, we've commenced a process to sell our Canadian E&P assets. We're targeting completing our exit from the region by the end of 2017.

We also continued to make progress in rationalising our Central Power Generation business. We've now closed the Killingholme gas-fired power station and we'll assess our options for the rest of our fleet in light of the capacity auction reforms.

In wind generation we concluded the disposal of the GLID joint venture in the first half and expect to dispose of our remaining wind asset, Lincs, by the end of 2017.

How are we doing in shifting our growth focus towards the customer-facing businesses?

As we said last July, our main focus areas for long-term growth are Energy Supply, Services, Distributed Energy & Power, the Connected Home and Energy Marketing & Trading. In Energy Supply & Services we are repositioning the organisation and our capability to underpin growth. We're also very focused on delivering higher levels of customer service, improved cost efficiency and offer innovation which we see as key to our success in establishing the platform for growth. And we've made progress in all of these areas in the first half of 2016.

In developing new businesses in B2B, we've also added significant additional capabilities in Distributed Energy & Power and in Energy Marketing & Trading over the past year. The acquisitions of Panoramic Power, ENER-G Cogen and Neas Energy all add additional complementary capabilities and customers which will allow us to accelerate our growth strategy. And in Connected Home, we've seen sustained growth in the number of hubs installed, launched five new products in the first half of 2016 alone, and expanded our horizons beyond the UK to other markets as we build an international business.

Let me expand on these areas briefly.

In our established channels of Energy Supply & Services, in both B2C and B2B channels we're seeing encouraging results. In our Home business units, as we invest more in customer service we're seeing significantly reduced complaints. In the UK we've seen a 38% fall in energy complaints in the first half, and this builds on the improvements we delivered last year. Over time we'd expect this to lead to an improvement in customer satisfaction, retention and brand NPS, which is the measure we're now reporting as part of our new suite of KPIs.

In North America Home, we also saw a similar fall in complaints and have delivered both stable customer numbers in energy supply, and in services an increase in the number of higher value protection plan customers.

We've been developing new innovative offerings. In the UK given the levels of trust we enjoy in our Services business and our on the ground presence and customer knowledge base, based on that we're introducing new risk-based pricing on home insurance products.

In June we launched our ‘Free Time’ tariff, which gives customers with smart meters the option of free electricity on a Saturday or Sunday. We've offered similar tariffs in North America, and this is a good example of us using our experience from one of our energy markets to provide customers with an innovative offering in another.

We continue to lead on the roll-out of smart meters in the UK, which we believe will provide a platform for improved customer relationships and for new skills development for our field force.

As you heard from Jeff, UK Business has now returned to profit and delivered strong adjusted operating cash flow in the first half of the year, with the delivery of working capital inflows as we resolve the billing issues we experienced last year.

In North America Business, as of the half year we’ve delivered a 37% uplift in margin under contract relative to a year ago, which will drive much of the improvement in financial performance we expect in the second half of the year.

So that covers progress in our established channels. I’d now like to turn to our newer businesses and we’ll begin with the capabilities we’re building in Distributed Energy & Power before moving on to talk about growth in the Connected Home.

In Distributed Energy & Power we are focusing our efforts on three offers to our customers, providing energy insights, asset optimisation and delivering energy solutions direct to the customer on their premises. The three highly targeted acquisitions we’ve made over the last year play directly into these pillars as you can see here.

The circuit level energy use disaggregation and analytics we acquired through Panoramic Power last year are already creating value for the customer, allowing them to take action and save costs or improve utilisation and productivity based on the insights received.

We continue to see good sales of our monthly subscription service to a diverse range of customers, including retailers, manufacturers, cinemas and healthcare providers, and we’re now receiving seven billion pieces of data a month from this channel.

We also improve our asset optimisation capabilities with the agreed acquisition of Neas Energy. Neas is one of Europe’s leading providers of energy management and revenue optimisation services for decentralised third party owned intermittent generating assets. It provides services today for 2,500 assets including windfarms, solar plants and combined heat and power units, with an installed capacity of approximately 8.6GW, nearly double the capacity of Centrica’s existing power fleet in the UK.

Importantly, Neas also adds enhanced analytics and IT capabilities, providing the tools with which we decide how best to optimise our customers’ assets and save them costs and maximise revenue. With a global trend towards power decentralisation, being able to optimise distributed assets effectively is the key capability to have. We expect to receive EU competition approval for the acquisition shortly.

Another aspect of the Distributed Energy & Power offering is the ability to deliver energy solutions direct to customers. We already offered solar PV, combined heat and power in the UK, and energy efficiency advice and solutions to customers, but the acquisition of ENER-G Cogen provides us with significantly expanded combined heat and power capabilities in the UK and internationally. It currently has around 1,400 units, totalling over 500MW under contract.

The combination of Panoramic Power, ENERG-G Cogen and Neas Energy with our existing capabilities provide us with a very solid platform with which to accelerate growth in Distributed Energy.

So let me turn to the growth we're beginning to deliver:

In Distributed Energy & Power, the number of active customers and total capacity under management have both increased organically over the past 12 months, before adding those customers resulting from the ENER-G Cogen acquisition in May. Including ENER-G Cogen, the number of customers has grown by a factor of nearly 2.5x to 2,450. Capacity under management has increased by 6% to 517MW.

And as you heard from Jeff, revenue grew and, importantly, the ENER-G Cogen acquisition provides us with a materially higher forward order book, underpinning future revenue growth.

Let me turn briefly to the Connected Home:

In Connected Home we continue to see solid growth. As I said earlier, we've launched five new products in the first half of the year, including active plugs, window and door sensors, motion sensors and active lights, all under the Hive brand, and Boiler IQ, our connected boiler product. We've seen good early sales of these products, whilst smart thermostat sales also remain strong.

All our connected products are powered by the same hub and controlled via the same 'App'. We recently introduced a new version of the 'App' with an even more intuitive user interface.

As you can see from the chart on the left, at the half-year we've installed over 360,000 hubs in the UK and we've sold over 400,000 products in total. We plan to launch our own smart thermostat and our entire suite of Connected Home products in the US around the end of the year.

So, in summary, we've made good progress in repositioning the portfolio and with delivery in all of our focus areas for growth in the first half of the year.

I recognise that it's not easy to capture everything we're doing with the businesses in two results presentations each year. As a result, we intend to host two Capital Markets events in the second quarter of 2017, targeted at providing much more insight into what we're doing in each of the B2C and B2B channels.

Let me next provide some additional insights into our cost efficiency programme.

As Jeff outlined, we're making very good progress in the delivery of the £750m cost reduction programme, which we expect to be delivered by 2020. First half delivery from our efficiency programme was £141m compared to the end of 2015. Total direct like-for-like head count was over 1,500 lower at the end of the first half than at the start of the year. We expect direct like-for-like head count to be 3,000 lower by the end of the year.

For the full year, we've increased our expected efficiency improvements and now expect to deliver around £300m of savings, roughly 40% of the 2020 target and an increase of £100m since February. This means we'll be able to absorb about £100m of inflation and still deliver a material reduction in our underlying like-for-like cost base. In turn, this creates the space for revenue investment into our growth areas and on a net basis contributes to operating cash flow growth. In any period there will be on-off items, as you saw, and cost phasing, but we will be able to report progress against the £750m target on a consistent basis going forward.

While our overall efficiency target remains to deliver £750m per annum of savings by 2020, relative to 2015, these early successes are de-risking overall delivery and accelerating value capture. They also underpin the confidence in our cash flow growth potential in the early years. I'm very encouraged by progress. A strong focus on cost efficiency and continuous improvement are essential components of our competitive strategy.

Finally, before summarising, I'd like to update you on how we're doing against our financial framework, including delivery of operating cash flow growth.

You'll be familiar with our financial framework we set out last year, which comprises the targeted financial conditions for the Group and helps evaluate our financial progress towards achieving the strategy.

In terms of cash flow, our goal is to deliver 3% to 5% per annum underlying adjusted operating cash flow growth, with a progressive dividend linked to this growth. We remain confident in delivering, on average, 3% to 5% growth per annum to 2020, relative to a 2015 baseline, in adjusted operating cash flow at flat real commodity prices. And although we're not suggesting it's sustainable, I'm pleased to see the estimated underlying adjusted operating cash flow growth of 11%, relative to the first half of 2015. We still consider 3% to 5% to be the right medium-term target.

In the early years, operating cash flow growth is underpinned by the strong progress we've made already on cost efficiency, other underlying performance improvements and an acceleration of our growth strategy in the customer-facing businesses. We're maintaining strong levels of capital discipline, with total Group capital investment, excluding material acquisitions, expected to be less than £1bn in 2016.

Another important aspect of the financial framework is maintaining strong investment grade credit ratings. Despite the continued strength of the Group's operating cash flows, and our ability to pay down net debt, even in a low commodity price environment, the credit metrics we target had begun to come under pressure. With the opportunities to access the targeted Neas Energy and ENER-G Cogen acquisitions in the second quarter, and the desire to underpin our targeted ratings in what continues to be an uncertain environment, as you know, we took the decision to raise equity in May. Partly to fund the acquisitions, but also to strengthen the balance sheet and reduce pressure on our credit metrics and the targeted credit rating. In terms of ROACE we continue to target a threshold of 10% to 12%.

So having covered our strategy, portfolio repositioning, progress in our cost efficiency programme and our financial framework and cash flows, let me recap on our progress towards the 2016 targets we set back in February.

I'm pleased to say that we're on track to achieve all of these. Full year cash flow is underpinned and we expect adjusted operating cash flow to exceed £2bn for the full year. Capital expenditure is on track to be below £1bn, including any small acquisitions, and within that, E&P capex is still assumed to be around £500m.

We now expect to deliver around £300m of cost efficiencies from our programme, more than £100m higher than our expectation in February, and therefore like-for-like operating costs are expected to be below those of 2015 in nominal terms, while like-for-like direct headcount will fall by about 3,000 over the year.

So now let me summarise.

Financial performance in the first half of 2016 was encouraging, despite unfavourable weather conditions in North America, continued low commodity prices and competitive intensity in the UK affecting customer numbers.

Our efficiency programme is ahead of target and we have increased our expectation for 2016 cost delivery to around £300m.

We've made good progress in implementing our strategy to reposition E&P and power and to develop our customer-facing capabilities. Full year cash flow and financial targets are all underpinned.

The actions we've taken leave us with a stronger balance sheet and a company which is more resilient in an uncertain environment. And we remain confident in our ability to deliver an average of 3% to 5% growth in underlying adjusted operating cash flow per annum until 2020 at flat commodity prices, underpinning a progressive dividend policy.

Thank you for your time and I'd now like to ask Mark, Mark and Badar to join Jeff and me on the stage to take your questions. Thank you.

And, as usual, what we'll do, I'll field the questions but obviously we'll cover the landscape as you see fit. So who would like to go first? Why don't we start with Deepa and then Fraser? I'll try and move it around. Deepa, congratulations on your new Hive, I hope it works well!

Q&A session

Question 1

Deepa Venkateswaran, Sanford Bernstein

Thank you. I have two questions.

So on the cost cutting, in terms of your accelerated targets and what you've achieved, can you just also relate it back to the £300m net target, what you've achieved year to date net, and then what you expect to achieve for the full year.

And the second question is, obviously having now just purchased the new Hive product, the one question I have is, when do you plan to launch 'energy plus services' or 'energy plus Connected Home product', which I think there should be immense potential there.

Iain Conn

Thank you very much, Deepa. Let me start with the cost efficiency and I'll ask Mark and Badar to just give you a sense of how we see bundled products and how offering more than just energy is changing the relationship with the consumer. I think that's really important to our strategy.

So on cost efficiency, if I understood your question correctly, we've indicated that the cost efficiency delivery from the programme was going to be £300m this year and not £200m. We're very pleased with progress. This is across a wide range of areas and, as you saw from Jeff's slide, also, very encouragingly, about two thirds is coming from operating costs and only about a third from cost of goods. So it's not like we're just chasing after the supply chain and not doing anything around our underlying costs, it's actually the other way round, and that £300m, as I said, is 40% of our £750m programme by 2020.

The relationship to that £750m is clearly that we are accelerating, effectively value capture, and we're de-risking the overall ability to deliver the £750m. And there's no question this has involved a huge mobilisation effort by the whole organisation, but we're very encouraged, it's coming from changes to organisation and the efficiency and effectiveness, particularly in Mark's area, in the UK & Ireland. The repositioning of E&P, as we're pursuing cash break-even, or, in fact, free cash positive outcome, even in this environment, we've driven some very big savings and are driving big savings in IT.

We're seeing valuable leverage of our scale when we look across the Atlantic. We've found contracts in the United States that we could apply to the scope we have here and save significant unit rates on both sides of the Atlantic. And we've found savings in the way we go to market, buying everything from servers through to end-user computing, so it's really across a wide range of things.

But, Deepa, did I answer the question on how it relates?

Deepa Venkateswaran

Sorry, my question was, when you communicated your cost cutting targets, you said £750m was the gross target and £300m would be delivered as net by 2020, so I was just wondering how.

Iain Conn

Actually that's not correct. We actually said £750m is the risked view of what we're going to deliver by 2020. We didn't say...

Deepa Venkateswaran

But I think then you assume that inflation and other things would offset it.

Iain Conn

I see what you mean, I'm sorry.

Deepa Venkateswaran

So I'm just trying to understand that £300m net target post-inflation, how would you say that target is progressing today and where would that be?

Iain Conn

Sorry, I understand now. So, basically, we said that the £750m target was obviously pre-inflation and inflation would eat up, based on a 2% to 2.25%, or something like that, inflation rate compound, it would eat up about £450m of the efficiencies on a net basis, leaving £300m as room to invest in our growth businesses. We also said that by 2020, because of that, we were confident that the nominal costs in 2020 would be still lower than the nominal costs on a like-for-like basis in 2015.

What we've shown you here is an absolute snapshot of exactly that, that what we're doing this year, despite £100m of inflation, estimated on a £5bn base, we are able to save £300m, leaving a net £200m, which gives us some space to invest in our growth businesses, which we are doing, and leaving the nominal cost base in 2016, at the end of the year, below 2015. So we're doing exactly what it said on the tin, if you like, and we still expect the same outcome by 2020. Obviously we'll keep the programme under review. It's going very well.

So Mark and Badar, just touch on bundling and how this plays into our strategy and customer reaction.

Mark Hodges

Deepa, I'm glad you have Hive as well. I'm glad you see the opportunity. And we already do have some bundling going on in the Services business where we've launched a Boiler IQ product, which can come, if a customer chooses, with the service contract.

So I think the short answer to your question is we see the same opportunity both across North America, and Badar will talk about what we're actually doing, and in the UK. In a post-CMA world with a different set of rules, we think that the combination of energy, services and insight products, so we have the MyEnergy live product where we give disaggregated information to customers, and Connected products, bringing those together into some exciting combinations over time is one of the things that should set us apart from the competition.

So it's just now a matter of us working through, as we go through into H2 this year, H1 next year, starting to work out which combinations for which customers, in which order, but we completely see that opportunity and, like you, I am enthused about it.

Badar Khan

Thank you, Mark. I think that, as we've talked about before, we've been on this journey for a couple of years now in the States, where the 'energy plus services or Connected devices' offerings have grown from 10% of sales, to 40% last year, around 40% to 50% in the first half of this year.

And I think the underlying premise is that we believe customers want to be more empowered, are choosing to be more empowered and want more control over their choices. And we're seeing that in the take-up and the receptivity. We're iterating around any number of different combinations of packages. And the results are that customers are staying with us longer and we have seen retention rates improve in our residential energy business. That's been a challenge for us for a long time, as you'll have heard about. We've managed to not decline the business, so it's slight organic growth in our energy supply contract base over the course of this year, which is also quite a change from the last several years.

And I think just to Mark's point about the competitive advantage, we have an advantage in the UK in the sense that we've been experimenting on this basis. We've just launched a free-day product in the UK. We've been experimenting with free Saturdays, free weekends, power of 100, choose your free day, in the States for a couple of years, so we can take these learnings from one market and apply them to another, which others cannot do, which other competitors in the UK aren't able to replicate.

Equally, in North America, we have real investments in Connected Home and Distributed Energy & Power that our competitor base in the United States don't have. And so we're taking those investments and applying them to North America. We've talked about launching our complete suite of connected products in North America towards the end of this year. So I think, as we think about Centrica as a global business, we've got real sources of advantage on accrediting businesses on both sides of the Atlantic, and that should set us up for success in the long term.

Iain Conn

Thank you, Badar, Mark. We'll go to Fraser next and then we'll come back into the middle here.

Question 2

Fraser McLaren, Merrill Lynch

Just three quick questions please.

The first on UK supply numbers. The 1.5% losses you reported in Q1 were attributed to expiry of contract, yet we've seen the same effect in the second quarter in spite of being more aggressive on your Sainsbury's offer. Do you think that you will be able to stem the losses? Will this need extra defence expenses, and how many of the Sainsbury's accounts did you add in the first half?

The second question is on pre-payment meter caps. Now you previously played down the likelihood of price controls here, but now that they are on the way, could you help to quantify the effect on margins please in 2017? Might it be as much as the £100m headwind as implied by the investigation conclusions?

And then just finally, a point of clarification please on the savings. Does the £300m include the extra £50m of lifting cost? Thank you.

Iain Conn

Thanks, Fraser. So, effectively, yes to your last question. The like-for-like base includes the like-for-like savings we're delivering in E&P, and so as we up our target in E&P, we're also upping our target at the Group level. In the first half, a lot of the savings, as I mentioned, came from the UK & Ireland portfolio and from E&P, but don't be too precisely mathematical about this. Only in one sense, we've said that the target for the year is around £300m and obviously we're not being precise about the final outcome and we'll see how we do.

In terms of the pre-paid meter caps, clearly, first of all, we did say that we didn't believe it was the right thing to do to introduce any form of price regulation. However, the CMA has clearly chosen to do that for a subset of the customer base. Exactly how this is going to work when it's implemented is going to be something that we still need to find out. And furthermore, we've still got to let the period of appeals for the CMA final report run its course.

In terms of the impact, we're not giving a financial number, but clearly the CMA have a view that it could be 30% market share multiplied by a £300m number and you get to the sort of number you talk about. But that's before we do anything about it and that's before we look at the offers that we're making, so before we invest in smart prepay, it's before we do more on our cost efficiency. And much of the reason for us driving an accelerated cost efficiency programme and being free to make new offers once the RMR restriction has been lifted, which it has, give us the tools with which to respond to things like this. Clearly if there was no ability to manoeuvre against it, you could get to some high impact numbers, but we've got lots of room to manoeuvre.

On the supply accounts in the UK, I'll ask Mark to talk a little bit more in a minute just what it's like at the moment, but clearly we have seen significant losses in the first half, 399,000. We're concerned about this, yes, but we're not totally focused on customer numbers. But there are particular circumstances in the first half, which I'd like Mark to talk into, that mean we went from last year, in the second half, actually, where we didn't lose many customers at all. And it's important to remember for the whole calendar year, the last year, actually our losses were also just over 3% as opposed to 2.7% in the first half.

You asked about Sainsbury's. One of the factors that drove the reduction is that we actually had our Sainsbury's channel offline in the first part of the year and actually we lost customers in Sainsbury's in the first half. So that's quite an important fact, and it's because it was offline.

I am pleased to say that overall, in June, we saw overall customer numbers in British Gas and Sainsbury's rise, so it's not like it just seems to be month by month falling away, but it's a very competitive market and clearly we've got to look in a post-CMA world where there are 44 competitors, we've got to look at ways to drive what customers want and target the customers who want them. And it's not, therefore, necessarily just about numbers.

And one of the things we need to come back and talk to you guys about next year is customer segmentation and how we're thinking about the different types of customer. You just talked about pre-paid customers; depending on how the CMA process rolls out, pre-paid customers might not be that valuable anymore and we have to think that through.

But, Mark, what's it like? What's it been like? And why are you losing so many customers?

Mark Hodges

Thank you, Iain! Let me pick up that very nice question.

I think just to put some colour around the numbers, in terms of the long term contract roll-offs, there was the big one in Q1 that we referenced at the Trading Update. We did have another one actually in the second quarter, so it was around 1.5m customers that came up for renewal, effectively, from a long term contract, and we actually renewed, across those two big events, 86% to 88% of the customers, which is, I think, a really strong number, and we actually think that our retention rates stand up well to the competition.

As Iain said, Sainsbury was out of the market for a couple of months. We actually lost about 5% net of the book, so slightly more than the overall for the total. Also the thing I've been reminding people of is that you've hit the peak potentially, or certainly for a while, of the difference between the fixed price deals and our SVT priced contract, because as commodity prices have started to furl up, we're seeing the fixed prices move up and the gap, which was at least £300, is now closing and is £200 and closing rapidly. So in terms of price consciousness for consumers, and we think that's a feature where we've hit a peak during that first half of the year.

And as Iain said, what are we doing? Well, I think it goes back to some of the fundamentals we laid out a year ago. We are reducing cost across the business so that we can be price competitive. We also – let's not forget – reduced our prices and that took effect in March, so that's playing through more into Q2 than Q1.

We are improving service, complaint levels down, service levels up generally, Net Promotor Scores improved. We think that will help retention. We are investing in the information and insight products that we talked about, and again, learning from Badar and North America, so we provide millions of customers with additional information about their energy usage to try and help them to save money and take more control. That has an impact on retention.

And we have launched now some new offers; so we have the Home Energy Free Time, the Free Saturday/Sundays. That's gone really well. We sold tens of thousands in the first few weeks and it's something that's grabbing lots of attention, it's something a bit different, and so we're positive about the potential that particular product has.

And as we move into half two, it's just worth remembering we're leading on Smart, we find the retention levels are high and the churn levels are lower and we'll continue to lead on Smart, we think. We're going to get more flexibility around how we communicate. What we actually put in the bill will become something we can have more determination over than the regulatory framework, and we think that's the kind of thing we can invest in. We can do more targeted offers, and I won't say exactly what's coming but there are a series of things we'll do. And, frankly, we're just going to keep trying to improve that service. Although it's got better, we still think there's more we can do as we go forward.

So all of that, as Iain said, gives us some belief that we can start to improve the quality of what we're doing for customers, but then the overall, how many numbers is the right number, as Iain said, I think we'll have to come back to and have a much longer debate. But just one final thought, we did grow in June and that's something that hopefully is a good sign for the rest of the year.

Iain Conn

Thanks, Mark. Badar, I know you want to say something briefly, because we've got a couple of other questions.

Badar Khan

Very briefly. Mark talked about the different offers that we're putting together for our customers and what we're seeing today, that we weren't seeing two years ago, is utilising data and data science and ways that, frankly, other consumer industries have mastered for quite some time, and we have a very large base to be able to deploy data science, effectively, to determine what is the customers' response to different types of offers and have that impact into our customer service. So what is the next best action? And I think that's another positive development, another source of potential advantage that we have. We roll-out smart meters, we roll-out the energy insight devices on both sides of the Atlantic.

Iain Conn

Thanks, Badar. We've got two in the middle.

<u>Question 3</u>

Jenny Ping, Citi

I've got three questions. Firstly, we all know about the Cheniere contracts coming in 2019, but in your statement you also talk about the completion of further FOB cargoes in the first half and expectations to do more in the second half. Can you just talk a little bit more about what you're doing there?

Secondly, just on the opex efficiencies, the £750m, I'm a little bit surprised that we actually haven't seen any cost to serve reductions on a per customer basis in the first half. Can you talk a little bit around that? And I know I asked you this question at the full year and I'm going to ask it again, can you put the £750m in context with the per customer cost of sales, what that means in terms of the 2020 target?

And then just lastly on the CMA review, can you also talk a little bit about the database that the CMA is looking to introduce and what that could potentially mean in terms of competition numbers and also margins? Thanks.

Iain Conn

Let me ask Mark Hanafin to talk to Cheniere and FOB LNG and I'll come back and touch on the other two.

Mark Hanafin

So the question was what are we doing on FOB LNG cargoes? We've just hit a milestone of doing our 30th cargo since we started in the last 18 months. The significance of it is that previously we were simply a purchaser of LNG into Isle of Grain capacity in the UK, and we're moving to having a global capability of buying and selling. So the significance of that increase that you're referring to is simply that when the Train 5 contract comes on, it will be FOB. It means we can take it anywhere in the world and extract value from that. So I think it's a very positive development that we're showing that we can build that global capability of buying and selling cargoes in countries all around the world.

Iain Conn

I think there's an update on Cheniere?

Mark Hanafin

There isn't really any further update. As you mentioned, 2019 is still the expected date of the start-up. We're obviously looking at the shipping options to get ready for that start-up, but nothing has changed.

Jenny Ping

Just a clarification point. On the cargo that you're signing up now, are there any terms and conditions as per the Cheniere contract that we've seen before, i.e., are we still talking about 15% premium to the Henry Hub prices? Are there more details you can give us on that?

Mark Hanafin

The cargos we're talking about, in terms of the stock cargoes, are being bought and sold all over the world. So, for example, one we've just done recently we bought from Bintulu in Malaysia and we've been marketing for that cargo, so it's not all related to the Gulf of Mexico.

Iain Conn

And on your other questions, firstly on cost to serve per customer clearly, the number of customers has come down in the first half and costs have come down and that's why the cost to serve per customer hasn't moved significantly. But also, a lot of our cost efficiency programme isn't directly in service of the customer. So there's quite a lot that we're doing above the level of customer service and the direct cost associated with serving customers. I've talked about some of the Group level savings that we're making, or savings in E&P, and of course, therefore, they don't feature in the cost to serve per customer.

So in the UK, it's about the numbers coming down, but the good news is the cost to serve per customer is not going up, and we expect it to be able to come down; it's a key performance indicator. But it also depends on how much high-touch offerings we develop. Some of them will have higher costs to serve, so it's not necessarily always a one-way ticket. What we want to be able to do though, is demonstrate the ratio between input costs and gross margin generation, and that's what I'd encourage all of you to be thinking about, and that's one of the KPIs that we've now given you in the extensive list of KPIs.

In the US, part of the reason the cost of service is going up is because of the mix in what we're delivering to those customers, and if you strip out the Services business in the US, the cost to serve, the unit cost to serve is pretty much flat.

On the CMA review and the database, it's early, early days. We haven't heard yet from Ofgem precisely how they're going to set this up, but clearly we're excited about it, because although everyone else wants to get at our customers that have been on our books for a long time, there's at least 70% of the market that we'd quite like to get hold of too.

So it's not all about everyone taking stuff away from British Gas, it's actually about us having a go at other people's customers too, so this is potentially a real opportunity for us. The things that we are worrying about are things like data security and fungibility of the database so it's easy to manipulate. And I don't mean it in a negative way, I mean manipulating the data. And it's not clear how Ofgem are going to do this. We believe they might ask for help from the suppliers in order to design it. It's early days.

Mark, anything else you have on it?

Mark Hodges

I don't think there's much we can say. It's not due to come into force until 2018, so there is quite a long way to go to do the design, to figure out how to operate the actual database, and, frankly, how to figure out how to engage customers. I think everybody's concerned with the notion that customers could be bombarded with literature. So I think there's an awful lot of water to flow under the bridge in terms of discussions with Ofgem and the industry generally, but nothing more to add Iain.

Iain Conn

Thanks Mark. Mark has been very patient, Ashley, and then Ed, two more here, so there's four in the middle.

Question 4

Mark Freshney, Credit Suisse

Two questions.

Firstly, on the old Connected Homes business, if you like, which is the Home Services business, which you don't give as much disclosure on. I notice the accounts are still falling there and I believe that's an important platform for you to grow the Connected Home business. So what are you doing there and can you give an update to trading conditions on that activity?

Secondly, a question for Jeff. Your strategy of focusing on cash flow is starting to deliver, you're through the big acquisitions, and it's perhaps a little bit premature to talk about capital deployment so soon after raising new capital, but when you start de-lever rapidly towards the end of next year, what would you look to do with the cash?

Iain Conn

So firstly, just to clarify one thing, Mark. Connected Home and our traditional Services business are very different. But, Mark Hodges, what's happening in the traditional Services business?

Mark Hodges

To be fair, the trends are very similar to the ones we outlined last year, the fundamentals, so there are some headwinds and people, typically, are moving away from insurance contracts to more on-demand, more emergency-based contracts.

You're right that you can actually see the disclosure in there about the number of customers. Also, I would say the other headwind for us has been that we've had to carry a 3.5% increase in IPT through the products and it's a relatively price-sensitive market. So the IPT increase came into force at the back end of last year and that's been working its way through. That hasn't helped in terms of our pricing. But, as ever, what are we doing about it? What's the reaction? We're reducing costs, which we talked about. Service is actually very strong in the Services business and always is. Our engineer service visit Net Promotor Score is plus 70. It's still a stunning product in terms of engineers visiting homes and fixing boilers.

So we are focusing on reducing cost, and actually if you back out the pension credit that was in last year's numbers, the underlying performance of the business has improved at the EBIT level. We're investing in some new capability, so we're looking at how we can grow our own on-demand business. Obviously I've talked about Boiler IQ, so we're investing in technology. And actually beyond that, we're investing in some pricing capability. Iain talked in his script about risk-based pricing. We're bringing, I think, some innovation into things that would be more typical in an insurance-based business, which this obviously is, around the size of house, age of boilers, types of boilers, postcodes, so we're starting to improve, I think, the capability around how we risk-assess individual customers. So those are some of the things that are going on in that business at the moment and we think that there is a very strong core around which we can build.

Iain Conn

And, Mark, just one other thing that is important to remember, which we talked about last year, having physical fulfilment capability on the ground with 12,000 people – we've got a couple of thousand in the US on our books and also franchisees, and a considerable workforce here in the UK. This allows us to do things where physical meets digital and to do things in a trusted way. Most of our competitors in the new product space can't do physical fulfilment and we think we can leverage that, especially if we leverage the smart meter rollout, the training in 4G and Wi-Fi connectivity that that brings. So there's quite a lot of potential and you'll hear more about that next year.

I know that there are lots of other questions, so let's move on. Jeff, what are we going to do when we de-lever, and we have de-levered significantly, but obviously as we de-lever the balance sheet, which has got to be a good thing, what are we going to do with the money?

Jeff Bell

It sounds like a quality problem to have at the end of 2017!

I think I'd go about this in a couple of ways Mark. The first, as Iain has indicated, we have committed to de-lever, we talked in May about looking to have a reduction in net debt between the end of 2015 and the end of 2017 of about £1bn. We talked about moving it from £4.7bn to the high £3bns. Clearly we're in that range currently at the end of June, although we haven't paid for one of the two acquisitions that was part of the equity placing that we did in June obviously. But the cash flow generation as you've indicated has been encouraging in the first half of the year. It does tend to be a bit weighted towards the first half but, nonetheless, we feel we're well on track against that goal, particularly for 2017.

I think the second piece I'd point to is when we talked about the financial framework at this time last year, we indicated that the reinvestment rate we saw as being up to 70% of the adjusted operating cash flow. Clearly we also indicated that in the current environment we were in we would cap that at £1bn for the first couple of years of the strategy. I think as we then get further out we talked about whether the opportunity with lower leverage, with higher cash flows, the opportunity to assess whether there were areas of the strategy that we would be able to invest further against to drive additional growth in value for shareholders going forward.

Iain Conn

Great thanks Jeff. I mean obviously what we're trying to do is deliver returns and growth for our shareholders and returns to shareholders is important in this equation as well as making sure that we invest in the business and keep the balance sheet strong.

<u>Question 5</u>

Ashley Thomas, Societe Generale

Thank you. Two question. One a follow-up on PPM, when should you be able to introduce SMETs 2 meters into that marketplace? And the CMA changed the formula for the regulated tariff, reduced the headroom but increased the cost to serve. Just on that formulaic change do you view that as value neutral to yourself?

The second question on pension funds and discount rates, because you've given us an update on the actuarial assumption, so you're going to be putting in £76m additional cash each year, what was the discount rate used for that because you've given us the IAS 19 numbers, was it the discount rate at the end of June, or the end of December or March 2015? And what discount rate do you use for the decommissioning liabilities? Is it the same discount rate as the gross operational cash flow?

Iain Conn

So Mark on the prepayment meters and SMETs 2 and the CMA formula, remembering that this process has still got a bit of time to run.

Mark Hodges

Yeah, on the formula I think I'd adopt the same position as Iain in terms of we're not disclosing the financial impact. As you say there are a number of moving parts that we're working through and it will really depend in the end on the response and what we do with smart pay as you go, what we do with costs and how we potentially segment.

On SMETs 2 I can be more definitive, it's really dependent on when the DCC comes into operation. We need that capability for interoperability, that's planned now to be around April '17 I think, it's not something we're in control of, obviously it's an industry solution. It has gone back a few times over the past year. We're working hard from our side to try and make sure it doesn't go back any further because we think that interoperability gives consumers choice, allows easier switching, and that's all part of the drive from the CMA. But that will be the determining factor, the technology from the smart metering side is there and ready to go.

Iain Conn

And Jeff pensions.

Jeff Bell

The question, we are and have announced we're in the midst of finalising our triennial pension deficit based as of March 31st last year. You're absolutely right the additional payments we will incur are spread over 14 years and are similar in size to what we incur currently. That'll be a short period. The new ones don't start until 2017 and there's a short period where there's a bit of an overlap but the cash flow impact is roughly similar over that medium to long-term.

In terms of the discount rate, the discount rate is on a different basis obviously than IAS 19 technical provisions basis, and the discount rate is one of a number of factors within the pension assumptions that we discuss and negotiate with the pension trustees. So clearly a little different in terms of when it's set obviously from a timing perspective, we've been at this for the last year. But it clearly reflects the fact that gilt yields and interest rates in particular have fallen over the last year.

Ashley Thomas

But in terms of quantum it's not the discount rate from March 2015 it's a more recent discount rate?

Jeff Bell

It’s more recent yeah.

Question 6

Edmund Reid, Lazarus

Thanks. Two questions. The first one is on Connected Home. I was just wondering how you view success in Connected Home? Obviously there's quite a lot of convergence with your energy supply business and your services business so is it around profitability, is it around deployment, is it about reducing customer churn, the guys who run that division what are they tasked to do?

On smart meters, 2.5 million installed I believe, what have you learnt from that experience? Is the cost as you expected? What’s it doing in terms of customer NPS and also customer churn rates?

Iain Conn

Thanks, Ed, these are both for Mark Hodges. One comment on Connected Home versus Distributed Energy & Power. You saw that I laid out a clear strategic framework for Distributed Energy & Power, I deliberately didn’t do the same for Connected Home but we did give you an indication of the types of areas that we’re working on and I would expect that you'll get much more in-depth understanding of this at the Capital Markets event I announced earlier in the second quarter next year. But Mark why don’t you talk to both of these?

Mark Hodges

Yes okay, thank you. So on Connected Home, Ed, without wishing to sound trite it’s probably most of the list that you asked in the question. So it will play a role, in terms of both in North America and the UK, reducing churn, increasing engagement, as Badar mentioned a little while ago there's the whole point of data and disaggregation and information. So it plays a huge role there underpinning some of those trends.

The team are targeted at the moment on a number of things. One of which is to actually get the product suite developed and make it ready for North America; so as you know in the UK we’ve launched the bulbs, the plugs, the contact sensors, the motion sensors, the new App. We’ve got the new thermostat. So we have a kind of ecosystem and a lot of effort is going into making sure we have something that really broadens the choice that consumers have and it’s not just a thermostat deployment.

Beyond that we do think there are other things we can do with Connected Home. We think from a retail sales perspective into the market that people can buy the products direct. Our primary focus, I think to start with, is much more on supporting the Direct Energy and British Gas brands, but there's no doubt as we build out that ecosystem the teams are targeted with revenue growth. And what you see right now in terms of the underpinning costs is obviously all the costs of that R&D product development that we’re bearing up front.

So that kind of hopefully gives you a flavour and, as Iain says, we can come back and give more detail when we talk about this next year.

On smart the costs are pretty much in line. We're up to a workforce of 3,000 people. We've installed two and a half million. We're significantly ahead of the market. The two specific questions you had on NPS, it's actually, the equivalent brand NPS is 18 points better so it goes from -2 to +16, so it's a pretty significant increase in customer satisfaction and that's because there isn't all the issues around billing. The whole process gets a lot easier from a customer perspective. And the churn that we're seeing is about two percentage points better than the average in the book, which is why, as I think I said earlier, we do think that leading on smart is the right thing to do, and given that the rest of the market will be playing catch-up there's lots of other things we're learning about, obviously how to install, how to make appointments, how to be as operationally efficient as possible in the whole process.

Question 7

Gus Hochschild, DECC

If I may turn to Power Gen, so I understand that Killingholme was closed, you had outages at Langage and you increased your tolling from Spalding, there's still a 57% or 53% increase to 4.7% terawatt hours, with regard to that can I ask one, what was your average load to plant?

And then secondly hitherto, in the past you've given us some indication and a breakdown of the operating profits for your nuclear fleet, your CCGT fleet and your renewables fleets. I was hoping you'd give us an indication at least of the quantum of how your CCGT fleet did over the half?

Iain Conn

Thank you Gus. Mark I think this all sounds like it's in your bailiwick.

Mark Hanafin

It is, I didn't quite catch the first part of the question you wanted to know the load?

Gus Hochschild

The load factor of the plants, your average load factor of the fleets, the CCGT Fleet?

Mark Hanafin

I'm not sure I have it as, load factors as a piece of data. I mean if we just go through it in steps. On the Lincs project load factor was 42%. On nuclear obviously the production of 6.2 terawatt hours at the half year, I'm not sure how that translates into load factor, but it's up there in terms of record levels, with the usual caveats around unforeseen outages I would hope that would continue in the second half and give us a very good outcome for the year.

In terms of the plants, we had seen an improvement in market conditions so in the Spalding tolling contract you see a big uplift in volume there.

We've been held back a little bit with our CCGTs used because of the problems that we've had at Langage where we had a problem with the steam turbine. And of course at Humber we took half of the plant down for a couple of years and we'll be bringing that back at the end of 2017. So we've fallen, I think, to the mid-85% when we should be up in the 90s for CCGT availability. But that's broadly how I think about performance of the assets.

Gus Hochschild

Again can you give us any form of the second part of the question in keeping with past disclosures where you've announced the losses of the CCGT fleet. I mean, presumably can I read across that it was more or less half of what it was, or more or less the same as last year or probably a bit worse in power prices?

Mark Hanafin

I think when we look forward in terms of the CCGTs, the peaking plants will only operate if they can be cash flow positive otherwise there's really not a lot of point in having them and they have been successful in getting STOR contracts. So they are cash flow positive. They're making small operating profits.

In terms of the larger plant, profitability obviously is still affected by pretty modest spark spreads, but they are positioned for the introduction of the capacity market and, of course, with the changes that the government have announced we will get an extra contract starting winter next year and that's when you'll see the profitability of those plants pick up.

Iain Conn

Jeff did you have anything on the load factors?

Jeff Bell

No I didn't.

Iain Conn

The only thing I've got is clearly nuclear load factor is very high, around 80%, but we've seen wind load factors in the low 40s and I understand as Mark said the thermal portfolio depends on the type of plant and what its role is.

Gus Hochschild

Okay but if it's 20% does that become ballpark-ish?

Iain Conn

I mean some of them are going to be in the 50s and 60s and some of them are going to be in the zero to tens, I mean it depends what their role is, I'm not going to give a single number.

<u>Question 8</u>

Martin Brough, Deutsche Bank

Just two questions. One is politicians clearly have a lot on their plates generally at the moment but do you think in the UK they're prepared for a situation where maybe we get back to price increases next year, especially on the electricity side there's a lot of costs coming through in terms of renewables, capacity payments, those kind of things?

And then secondly on solar. Do you see your solar offering as profitable at this stage in the UK? Obviously solar can be a bit of a stop/start activity as prices and subsidies and customer behaviour changes. Are there any lessons from the US in terms of how you manage over time a business that can be a bit stop/start and where take-up can be variable and try and get your scale but without having costs that are too fixed?

Iain Conn

I'll pass the solar question to Badar in just a second. On the UK government and price rises, I mean this has been a somewhat frustrating element to our discussions with the CMA. If I start there, in that we have pointed out a number of times and I understand Ofgem have too, that the CMA was conducting its investigation in a particular moment in time when prices were falling and, therefore, this difference between SVT and fixed expanded, as Mark said earlier, and it's a bit like comparing fixed and variable mortgages I mean they are completely different things. And we pointed out to the CMA and the government that in 2010, I think it was 2010, fixed contracts were higher than the variable. And as Mark Hodges said earlier, we've seen a number of the fixed market increase prices quite a lot recently, some of over £100 differences in one go, and I think from memory there's 15 of our competitors have moved prices up recently. This has started to compress the difference.

I think that Ofgem are very aware of what this can do to participants and potentially even, we've seen it before, people actually can't handle the financial volatility and some people have in the past gone out of business in situations like this. A big issue with the CMA was we don't just meter it and sell it, as somebody said at the weekend, we actually manage this risk and it's quite a big balance sheet that you need in order to do it.

So I don't know about the Government. Unfortunately the Government has just all changed, I will be seeing some of them tonight, I don't know whether this will come up but it's our duty to warn the Government that this dynamic could, if prices do continue to rise, could create issues in the market. I don't know how ready they are.

On solar, just one point I want to make, strategically we are not in the pile it high, using other people's money and selling it cheap, revenue growth, where's the cash flow, type of solar business. We're in much smaller, rather more traditional install of equipment but, Badar how's it going? Is it doing okay or not so okay, and what's your thoughts? And then Mark, I don't know if there's something you want to add in a minute on the UK and Distributed Energy & Power? So, Badar.

Badar Khan

Yeah, I mean I think your question was on the UK but I'll certainly give you a perspective on the US and clearly generating energy, distributed energy from solar is a source of very material growth that we've seen for a generation in the United States and so it's clearly here. As Iain has said however the ability of almost every company in that sector to generate actual cash flow is probably a work in progress. That's probably the best way of putting it.

Our participation is quite narrow in that it's the residential rooftop solar installation and our lessons here already are around a high growth business. This year we'll have installed three to four times what they were in 2014. So the business is growing at a very rapid pace and we're learning all of the things you'd expect us to learn.

What we have been doing just very specifically this year is executing on those learnings. So we've been looking at the profitability and productivity of an individual job site and crew. So a series of changes to improve the profitability and productivity at the site and crew level.

The sales and marketing channels that we've been utilising to generate leads and close leads, we've been exercising any number of different channels in the last two years, we've got enough learnings now to know which ones work and which ones don't work, and we've been executing those changes this year.

Simplifying the offer, we've been developing offers that are almost custom to every individual customer and that's clearly not a route to scalability. So, as we've been learning what offer resonates most with which type of customer, we've now started executing on really simplifying the offer considerably since the beginning of this year.

And lastly, we've just taken a look at the locations that we have across North America and which ones frankly we don't see any near or medium-term site profitability and so we've closed 6 of our 14 locations. They're not core markets in terms of energy and services, traditional services locations. And I think all of that will lead to a turnaround in the profitability of the business quite clearly.

I think in the longer term the only different point of view I have today versus two or three years ago is in the United States rules around net metering in different. States are changing to the point where customers are actually less advantaged than we thought two or three years ago in terms of generating their own electricity from their own source.

That's probably the macro and micro story.

Iain Conn

Thank you Badar and Mark in the UK?

Mark Hodges

Yeah I mean obviously the government's been reducing its support for solar in the UK. So I think in the I&C space, particularly behind the meter, the important thing looking forward is what's going to be the combination of rising power prices, continuing declines in panel prices and the help that we'll get from new technologies like battery storage that improves the economics. So at the moment the demand has really been sort of deadened but we're maintaining our capability because we think that, certainly behind the meter and the I&C segment there could be significant demand in the future.

Iain Conn

Thank you guys. Now I've got a question from John Musk. Three more questioners have got their hands up and I think we should then call it a day; you've been very patient. I'm just checking there aren't any more. So John?

<u>Question 9</u>

John Musk, RBC

Yes, two questions from me. Firstly on Rough, can you just maybe give a bit more colour on exactly what's gone wrong there, and I know you said you expect losses for the full year, but what's the worst case if you aren't able to resolve the issues?

And then secondly, on EPS. I know that's not something that you necessarily like to focus on but unfortunately we do. Where do you think you are sitting for 2016 versus current consensus?

Iain Conn

Okay, so I'm going to answer the Rough one and start the EPS one and pass to Jeff. On Rough, first of all it's not so much something's gone wrong, it's the fact that every year we've pumped this old field up to full pressure and then let it down again and we've run lots of tests on it over the years; but last year in March we decided we'd better really check that the well stock in the field, the tubes that carry the gas both in and out, how corroded or eroded are they, and we had a pretty good idea but we wanted to check.

And secondly in terms of the casings around the wells and the seals at the top of them, these things over time deteriorate and we just thought we needed to do a comprehensive check, because we needed to understand the future life and integrity of the field. So that's what we're doing. It wasn't caused by some sort of safety event or anything like that, but in doing this we have found so far, and we've disclosed this, we've run a number of callipers to test the tubing, and actually so far, on about half the wells we've actually been very pleasantly surprised by the results, and on the casing seals we've run tests on only a small number of wells so far and actually five out of six or something like that have been absolutely fine.

We had one issue in June which caused us to issue a REMIT notice where we did have a lower pressure threshold in that well and we said, "Look, we need to first of all resolve it or seal it off." And then the question it raises, John, is well if there is uncertainty about the second barrier in some of these wells, and by the way, there's no integrity issue fundamentally, the primary barrier is very strong, but if there is any uncertainty about the secondary one we really have to check all the wells and check everything about all the wells. And that's going to tell us how long the field is likely to be viable, what's the sort of quality of the well stock and what's the future investment requirements of the field.

So that's what we're doing, and as a result of the June event we decided to finish this properly - it's going to take until March or April next year - because of the failure mechanism in that one well we just don't want to run the risk, as a prudent operator, of continuing to pump up the pressure until we've assessed the well stock.

Now, some people would say that's an abundance of caution but we think it's the right thing to do. We'll then have two bits of data, the commercial realities of spreads, which as Jeff showed you have been coming down, and how robust is the field to continue to be operated as a storage facility. And that's what we're doing.

On EPS, look, we don't give forward guidance on EPS, but Jeff in May said that we were comfortable with where consensus was for the year, and obviously we've beaten consensus for those that provided estimates in the first half, and clearly the bit that you didn't see was the efficiency programme and we've seen some quite strong performance elsewhere.

The second half has a whole bunch of pluses and minuses associated with it and that's why we're not giving guidance but clearly so far, so good versus consensus. But Jeff, what would you say about the factors that we're thinking about for the second half?

Jeff Bell

Yes, I mean clearly in the second half some areas have been going well, you know, cost efficiency programme delivering at or ahead of our expectations. We did have a lower first half for instance in North America because of the weather. As we said, we do expect strong recovery and a very strong second half from North America in a sense in the plus column. At the same time storage obviously, those issues have come to light over the last few months and will create a headwind in the second half. And the Cygnus gas field, the first gas is delayed from where we would have thought a few months ago, so all of those, a bit of plus and a bit of minus.

Iain Conn

Thanks Jeff. Iain over this side I think. And then we had two more, we'll go there and there and then finish. Thank you.

<u>Question 10</u>

Iain Turner, Exane BNP Paribas

First, talk about the Connected Home business and what you think the path to profitability in that is from here, if you have any, because obviously you're making costs of about three times revenues. Obviously it's an embryonic business but over what sort of timetable do you see that reaching profitability?

Iain Conn

So the answer we gave last year was that we expect to invest an additional £500m in the Connected Home business by 2020 and it would be beginning to become material to the Group around the end of that period, that's what we said. Obviously we do make money per unit on the hub and we're making money on selling the products, but we're generating gross margin while we're investing quite a lot into the pipeline, and so what I know we haven't done, which is frustrating for you, is to separate the unit profitability from the pipeline investment.

When we get to the second quarter of next year we'll take your question and Ed's question and others and actually help you understand the strategic frame, but the goal is still the same, that the Connected Home business, which has indirect benefits for existing businesses and direct benefits within itself, how it fits into B2C and the B2C offering and its future prospects, we will update you then. But clearly it has the potential to be explosive in its growth. But we've just got to be careful about getting it right first and not running before we can walk.

<u>Question 11</u>

Elchin Mammadov, Bloomberg Intelligence

Two questions please, the first is on acquisitions. You've done three already as we've seen. Going forwards are you going to focus on integrating them and possibly growing organically or shall we expect more acquisitions to 2020, particularly in Connected Home?

The second question is on storage. Yes, the outlook for this year doesn't look good, at the same time SBU prices have fallen and have been falling consistently so what is the rationale of having storage at times when you're shrinking in E&P and we've got some LNG coming up and the capacity's under-utilised and you can use it as a storage as well. So what is the rationale for storage? Thank you.

Iain Conn

So very briefly, I mean you're asking a very good question which is the UK is increasingly plumbed into other parts of the world. Does it need storage? The flip side of the argument is that the UK's got very low levels of storage relative to the size of the UK market, the continental markets have got much more storage. Now technically we're plumbed into those as well now, but in a very cold winter when things are all getting extreme in the Continent of Europe everyone's going to be competing for this storage.

So there's a dialogue to be had with the Government as well as our own assessment of how things might be in the future. I mean it's becoming quite a potentially polarised set of scenarios so that's as far as I'm prepared to go at the moment because we're reviewing it and, well the department formally known as DECC have made some statements about it recently, about the need for storage or not. It's an open question, that's all that we can say.

On acquisitions, we always will have the potential to do acquisitions as part of building the company. We have said very clearly that small acquisitions are part of our ongoing capital framework and, therefore, we always reserve part of our organic capital including small acquisitions for the possibility of adding acquisitions into particularly our customer-facing businesses. We're not currently working on it to any level of detail or definition any material things, I said that in May when we announced the ENER-G and Neas acquisitions, those were the biggish ones we'd been working on, but we don't rule out acquisitions, if that makes sense for all of you and for the company as a whole.

Last question and then just a quick sum up.

<u>Question 12</u>

Dominic Nash, Macquarie

Two questions as well as the dreaded gas storage one, which is again, is there anything to actually stop you from walking away from that asset, and if you were, could it be sort of like nationalised or used by somebody else?

And secondly on operating cash flow guidance, has that actually remained unchanged between the start of the year and now at sort of round about £2bn; or is it a fair assumption that you've got £100m of extra cost cutting we should expect to see a higher operating cash flow come through?

Iain Conn

So we haven't changed the guidance for the year but it's kind of obvious that we've made £1.4bn of operating cash flow in the first half and our target for the year is £2bn, so we are hoping to beat the £2bn and we're just repeating that we believe we can.

On storage, we are bound by undertakings, regulatory undertakings, to provide certain quantities of storage, unless there's some event such as recently which obviates the need to do so in the near term. So we're bound by that. And if, and only if, we decided to change our strategy in relation to storage, would we have to then discuss with the Government and regulator about whatever appropriate changes to the undertakings were necessary.

But that's not something that we can talk about at the moment, we're very clearly bound by it and only if we changed our positon on storage would we have to do that. We just recently renegotiated the undertakings with the Government and so we've got a freshly minted set of obligations.

Dominic Nash

Does that mean that you might not be able to get rid of it if it becomes like a millstone round your neck?

Iain Conn

No, it's something that within a reasonable period of time, I mean a short period of time, we would be able to get into good faith negotiations. I mean it's a commercial business at the end of the day, it's not a subsidised business. And so we have our commercial rates but we couldn't just stop it tomorrow because we have obligations to adhere to.

Concluding Comments: Iain Conn

Ladies and gentlemen, you've been very patient and thank you very much for all your interest. If I may say I was particularly pleased to hear so many questions about the strategy of the Group and what's underpinning it all.

In terms of what I hope you take away it's simply that these have been an encouraging set of results. In the circumstances we are very focused on the customer, I think you've heard a lot of evidence of that today and we're making progress on the portfolio to do that, and we're trying to move away from just a pure energy commodity supply relationship with those customers.

Thirdly, our strategy's on track and we're moving it forward in all of the dimensions.

Fourthly, we have underpinned the company with a stronger balance sheet over the last few months, which we think is a very wise thing to do in the context of Brexit and other things. And, last but not least, our guidance is unchanged, we're on track for our targets and the 3% to 5% operating cash flow growth remains. Thank you very much indeed for your attention.